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No. 84-307

In the Supreme Court of the United States

OCTOBER TERM, 1984

SOUTHERN BANCORPORATION, INC., PETITIONERS

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

BRIEF FOR THE UNITED STATES IN OPPOSITION

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QUESTION PRESENTED

Whether the court of appeals, reversing the district court, correctly determined that petitioners had failed to introduce probative evidence to establish that the fair market value of a portfolio of bank loans exceeded the face value of the loans.

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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. A1-A23) is reported at 732 F.2d 374. The opinion of the district court (Pet. App. A24-A71) is unreported.

JURISDICTION

The judgment of the court of appeals (Pet. App. A72-A73) was entered on April 17, 1984. A petition for rehearing was denied on May 30, 1984 (Pet. App. A74-A75). The petition for a writ of certiorari was filed on August 28, 1984. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

Petitioner Southern Bancorporation is a bank holding company. One of its subsidiaries, petitioner Southern Bank and Trust Company (Southern), is a South Carolina bank based in Greenville. American Bank and Trust Company (ABT) was another South Carolina bank which, unlike

Southern, had experienced financial difficulties. On September 19, 1974, the FDIC notified Southern and five other South Carolina banks that ABT would be closed by state banking authorities on the following day (Pet. App. A33). The FDIC solicited bids from the six banks for ABT's operations (*id.* at A33-A34).

Under the terms of the bidding, the successful bidder was required to assume $136 million of ABT's liabilities, which consisted mostly of checking and savings accounts (Pet. App. A34-A35). The FDIC agreed to take over from ABT questionable loans with a face amount of $61 million (*id.* at A5). The successful bidder would acquire ABT's other assets, consisting of loans with a face amount of $41 million, cash and securities worth $35 million, and other assets with a fair market value of $6 million (*id.* at A47-A48). The FDIC agreed to make up in cash the difference between the value of the assets to be acquired and the amount of liabilities to be assumed, with the stipulation that any "premium" bid by the assuming bank would be subtracted from the FDIC's promised cash infusion (*id.* at A37). The "premium" offered by the banks bidding for ABT's operations thus equalled the amount of "excess liabilities" they were prepared to assume.

In preparing their bid, Southern's officers ascertained that Crocker National Bank of San Francisco had recently acquired a bank from the FDIC in a similar transaction, bidding a premium equal to 5% of the acquired bank's deposit base.[1] Based primarily on the Crocker transaction,

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[1]This is a standard formula used by bankers in determining the going-concern value of a bank. See *Banco Nacional de Cuba* v. *Chase Manhattan Bank*, 505 F. Supp. 412, 461 (S.D. N.Y.), modified, 514 F. Supp. 5 (1980), modified and aff'd, 658 F.2d 875 (2d Cir. 1981); *Midlantic National Bank* v. *Commissioner*, 46 T.C.M. (CCH) 1464, 1466-1467, 1471 (1983). See also 1 A.S. Dewing, *The Financial Policy of Corporations* 304-305 (5th ed. 1953).

Southern submitted a bid of $5,560,000, an amount that approximated 5 percent of ABT's $112 million in deposits (Pet. App. at A8, A48). Those deposits were maintained in 29 ABT branch banks located in some 20 South Carolina communities, none of which was currently served by Southern (Pet. App. A7; C.A. App. 169-172, 174-176).

Southern submitted its bid on Friday, September 20, 1974, the day after the FDIC's solicitation. Within a few hours it was notified that it was the successful bidder (Pet. App. A37-A38). In accordance with the FDIC's terms, Southern sent teams of its employees to all of ABT's branch banks over the weekend to remove signs referring to "American" and to replace them with signs referring to "Southern." On the following Monday morning, all former ABT branches opened for business as branches of Southern. Television, newspaper and radio advertising was purchased to assure depositors that their funds were safe. Southern continued to operate 26 of ABT's 29 branches throughout the nine years between its acquisition of ABT and the trial below; three branches were closed or consolidated at some point. Pet. App. A20-A21 & n.9, A37-A40; C.A. App. 433-436.

In preparing its 1974 federal income tax return, Southern sought its accountants' advice about the proper characterization for tax purposes of the $5,560,000 premium that it had paid to acquire ABT. As noted above, that premium represented the excess of the liabilities that Southern assumed over the face amount of ABT's loan portfolio plus the fair market value of ABT's other assets. The accountants suggested that, because the FDIC had taken over many of ABT's bad loans, ABT's remaining loans were of high quality, *i.e.*, were relatively more likely to be repaid, and hence allegedly had a fair market value in excess of face. Southern and its accountants then devised a complicated methodology for valuing the loans. ABT's installment loans

(*e.g.*, car and boat loans), which had a face value of $18 million, were determined to have a fair market value of $21 million on the theory that their yield was slightly higher than the average yield on Southern's existing portfolio of installment loans (Pet. App. A56-A57). ABT's small business loans, which had a face value of $23 million, were sampled and graded according to their "quality" — essentially, their likelihood of being repaid — and were assigned premiums based on quality, to produce an asserted fair market value of $25 million (*id.* at A52-A53). Based on these calculations, Southern concluded that the fair market value of ABT's loan portfolio exceeded its face value by $5 million, that $5 million of the $5,560,000 premium Southern had paid thus represented a "loan acquisition cost," and that this loan acquisition cost should be amortized (deducted) for federal tax purposes over the useful lives of the loans. Petitioners accordingly claimed an amortization deduction for 1974 in the amount of $589,241, producing an operating loss which they sought to carry back to generate tax refunds for prior years (*id.* at A12). Southern allocated the balance of the premium it had paid to acquire ABT —$560,000 — to "goodwill," *i.e.*, to the going-concern value of ABT's business (*id.* at A64). Goodwill is not amortizable for federal tax purposes and no tax deductions can be claimed with respect to it.

On audit, the Commissioner determined that the fair market value of ABT's loan portfolio was, if anything, lower than its face value, since the loans' average yield was lower than market interest rates prevailing in September 1974. In the Commissioner's view, therefore, no part of the $5,560,000 premium could reasonably be characterized as a loan acquisition cost, since no one would pay a "premium" to acquire a loan portfolio with a below-market interest rate. The Commissioner determined, rather, that Southern had paid the $5,560,000 premium to acquire the going-concern value represented by ABT's chain of 29 branch

banks and its established relationships with its depositors, borrowers, and other customers. Since goodwill is not amortizable for tax purposes, the Commissioner disallowed Southern's claimed amortization deduction.

2. Petitioners paid the resulting deficiencies and sued for refunds in the United States District Court for the District of South Carolina. In support of their claimed amortization deduction, petitioners relied exclusively on testimony concerning the "quality rating" methodology described above (Pet. App. A51-A60). The government argued that petitioners' methodology was defective as a matter of law; that the loans were worth less, not more, than face; and that the evidence showed Southern to have paid the $5,560,000 premium for ABT's going-concern value (Pet. App. A14, A55; C.A. App. 406-419). The district court rejected the government's arguments, finding that the loan portfolio's fair market value exceeded its face value by $5 million as petitioners contended (Pet. App. A55-A60). The court acknowledged that "the deposit relationships and the locations acquired [by Southern] ha[d] some of the characteristics of goodwill," but found that, "whatever the value of the deposit relationships and the banking locations may have been, that value did not exceed the $566,060 which [petitioners] allocated to goodwill for federal income tax purposes" (*id.* at A63-A64).

The court of appeals unanimously reversed (Pet. App. A1-A23). It noted that petitioners bore the burden of proving their entitlement to a refund (*id.* at A18) and concluded that they had not "sufficiently established" by competent evidence the fair market value of the loan portfolio (*id.* at A17 n.8). Southern, the court noted, had done "nothing to establish that a sale of the loan portfolios on the open market on the sale date * * * by a willing seller to a willing buyer would have yielded any greater sum" than the face values of the loans as set forth in the FDIC prospectus (*id.*

at A18-A19). The court observed that the manner in which Southern had determined its $5,560,000 bid —multiplying ABT's $112,000,000 deposit base by 5% — necessarily evidenced a primary focus on the going-concern value of the ABT branch banks in which those deposits were maintained (*id.* at A8-A9). And the court concluded that the "quality rating" methodology Southern later used to support its alleged $5 million loan acquisition cost — a methodology that was "totally *post hoc*" since Southern did not evaluate (and had no time to evaluate) the quality of the loans before purchasing them (*id.* at A15, A16-A17) — was "comprised exclusively of imagination and speculation" (*id.* at A21). The court accordingly held that the district court had erred in failing to enter judgment for the United States.

ARGUMENT

1. Petitioners assert that the court of appeals did not base its reversal on a determination that the district court's findings were clearly erroneous or that its reasoning was legally deficient, but simply substituted its judgment for that of the trier of fact (Pet. 5, 12-18). Petitioners accordingly maintain that the court of appeals' holding violates Rule 52(a) of the Federal Rules of Civil Procedure, and that it conflicts with various decisions applying that Rule (Pet. 23-24).

Petitioners' assertion is altogether without merit. Although the court of appeals did not explicitly employ the words "clearly erroneous," it determined that the district court's finding of ultimate fact (the fair market value of the loan portfolio) was incorrect, because the only evidence petitioners introduced to support that asserted value (the "quality rating" methodology) was inherently defective as a matter of law. Indeed, petitioners make no attempt to defend their "quality rating" methodology, and at no point do they even contend that the Fourth Circuit erred in finding it faulty. Because the court of appeals applied the correct standard of review, and because the sole remaining

question is an essentially factual one concerning the fair market value of property, this case does not warrant further review.

The court of appeals' holding on the valuation question, moreover, was manifestly correct. As the court observed (Pet. App. A18-A19), petitioners did not introduce any evidence to show what the ABT loan portfolio would have sold for in the open market. Nor did petitioners show that the ABT loans bore a higher interest rate than the rate prevailing in September 1974 for loans of comparable terms and risk, as would necessarily be the case if the loans were worth more than their face amounts. Petitioners thus ignored the fundamental principle of tax law that fair market value must be determined objectively by reference to what a willing buyer would pay a willing seller in the open market. See, *e.g., Kimball Laundry Co.* v. *United States*, 338 U.S. 1, 6 n.3 (1949).

Instead of introducing probative evidence of this sort, petitioners relied solely on testimony about their "quality rating" methodology in an effort to demonstrate that the ABT loans were worth $5 million more than face. This methodology, however, was defective as a matter of law and could produce no probative evidence of fair market value. The fact that the average yield on the ABT loans was higher than the average yield on Southern's existing portfolio of loans (Pet. App. A56-A57), for example, is irrelevant in determining whether the ABT portfolio was worth more than its face amount. Obviously, if both sets of yields were lower than prevailing market rates, *both* portfolios would be worth less than face, although ABT's portfolio might be relatively more valuable than Southern's.

Similarly, the fact that the ABT loans Southern acquired were of higher "quality" than the ABT loans the FDIC took over (Pet. App. A52-A53) is also irrelevant to the question of fair market value. A Treasury bond bearing a 5% interest

rate, at a time when market interest rates have risen to 12%, is virtually certain to be repaid and would merit a high "quality premium" under Southern's formula, despite the fact that the fair market value of such a bond would be less than face prior to maturity. Obviously, the "quality" of ABT's loans was reflected in the interest rate ABT originally charged its borrowers. Absent evidence that those borrowers' creditworthiness had improved —evidence that Southern did not offer, and evidence that might be hard to come by given ABT's failing circumstances — the "quality" of the loans would not cause them to be worth more than their original face amounts.[2]

In sum, petitioners introduced no probative evidence of the loan portfolio's fair market value. The court of appeals thus held correctly (Pet. App. A22-A23) that they had failed to carry their burden of proof.[3]

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[2]Indeed, what little hard evidence Southern did submit indicated that ABT's loans were worth less, not more, than face. For example, the average yield on the ABT installment loans — car and boat loans generated over several years — was about 10.6% (C.A. App. 46). During the two-year period immediately preceding Southern's acquisition of those loans, however, the prime rate had risen from 5.5% to 12%. 60 Fed. Res. Bull. A32 (1974); 60 Fed. Res. Bull. A28 (1974). It is thus obvious that those loans were worth less than their face amounts. Compare C.A. App. 46 (average yield on ABT commercial loans was 8.4%) with C.A. App. 47 (federal funds rate estimated to be about 10.25%).

[3]Petitioners repeatedly criticize the court of appeals (Pet. 13, 15, 25) for suggesting that the "quality rating" methodology petitioners employed at their accountants' suggestion amounted to "ingenuity approaching fraud" (Pet. App. A3). While we would not necessarily subscribe to that characterization, the court of appeals was not without record support for its observation. In a financial statement filed with the SEC shortly after Southern acquired ABT, petitioners' accountants took the position that the $5,560,000 premium was properly to be treated as an intangible asset and amortized over 40 years. This reflects the accountants' understanding that the premium was attributable to goodwill or other intangible assets (such as going-concern value) not specifically identifiable having a useful life of 40 years, and not, as the accountants testified below, to a specifically identifiable portfolio of

2. This case has nothing to do with *Anderson* v. *City of Bessemer City*, No. 83-1623 (argued Dec. 3, 1984). The question there is whether the Fourth Circuit misapplied the "clearly erroneous" standard of review prescribed by Fed. R. Civ. P. 52(a) in reversing the district court's findings of fact in an employment discrimination case involving credibility and motivational determinations. The instant case does not arise in such a context and the factual questions it presents are of a wholly different nature. Here, the court of appeals' reversal was premised on a conclusion that petitioners' "quality rating" methodology did not constitute probative evidence of fair market value as a matter of law —a conclusion that has no parallel in *Anderson* and which wholly eliminated any evidentiary basis for the district court's judgment. There is accordingly no reason to hold this case pending decision in *Anderson*.

3. Finally, petitioners err in contending (Pet. 30-34) that they are entitled to a remand for determination of their alternative claim that the $5,560,000 premium was paid for ABT's deposit base, and that they are entitled to amortize that premium over the deposits' (as opposed to the loans') useful lives (Pet. 31 n.5). As the court of appeals stated (Pet. App. A9-A10 n.2), petitioners abandoned that alternative argument and introduced no evidence whatever of the expected "useful life" of the deposits involved. There is thus no basis for a remand on that issue. See *United States* v. *Janis*, 428 U.S. 433, 440 (1976) (taxpayer in a refund suit has the burden of establishing not only that the Commissioner's determination was wrong, but also of producing evidence to demonstrate his correct tax liability).

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loans having a useful life of less than five years. See AICPA Accounting Principles Board, Op. 16, at ¶¶ 42-44, 87; Op. 17, at ¶¶ 28-29 (1970); Financial Accounting Standards Board, *Interpretation No. 9, Applying APB Opinions No. 16 and 17 When a Savings and Loan Association or a Similar Institution is Acquired in a Business Combination Accounted for by the Purchase Method* at ¶ 8 (1976).

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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